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No. 824

In the Supreme Court of the United States

OCTOBER TERM, 1936

W. A. THOMAS, COLLECTOR OF INTERNAL REVENUE,
PETITIONER

v.

J. J. PERKINS ET AL.

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE PETITIONER

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OPINIONS BELOW

The opinion of the Circuit Court of Appeals (R. 96) is reported at 86 F. (2d) 954. The opinion of the District Court (R. 15) is reported at 15 F. Supp. 356.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered December 18, 1936. (R. 100.) Petition for writ of certiorari was filed on March 17, 1937, and granted on April 5, 1937. The jurisdic-

tion of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

By virtue of a contract of assignment, the taxpayers owned an undivided fractional interest in an oil and gas lease, and, in addition to a cash payment made at the time of the assignment, were obligated to pay to the assignors a further sum as oil payments if and when a certain amount of oil was produced from the property. Should the taxpayers' gross income include that part of the proceeds from the sale of the oil which was paid to the assignors of the lease as oil payments under the contract?

STATUTES INVOLVED

The statutes involved will be found in the Appendix, *infra*, pp. 21–22.

STATEMENT

The petition of the taxpayers, who are husband and wife, filed in the District Court, seeks to recover a portion of the income tax paid by them for the year 1933 upon their community income. (R. 4–9.)

J. J. Perkins, the taxpayer, in association with W. J. Green and the Faith Oil Corporation, was interested in certain oil and gas properties located in East Texas. (R. 21.) The interest of Perkins in the property here concerned was at all time in-

volved herein an undivided three-eighths part of the joint interest. (R. 21.)

Among the properties operated by these parties was a property covered by a lease which may, for convenience, be called the Hammonds and Branson lease. (R. 21.) On July 24, 1931, the Hammonds and Branson lease was assigned to Faith Oil Corporation, which acted for itself, Perkins, and Green. (R. 21–23, 27–29.) The pertinent portions of this contract of assignment are set out in the record (pp. 21–23). The contract recited a consideration of $10 cash paid and the further sum of $395,000 to be paid out of one-fourth of the oil produced until that amount was paid in full to the assignors by the purchasers of the oil. The actual consideration for the contract, however, was $105,000 in cash, notes for $50,000, which were later paid, and the contingent oil payments. (R. 27.) This oil payment was to be made only if, as and when sufficient oil was produced, and it was stated that the payment should not constitute a personal obligation of the assignees. (R. 22.)

At the time of this contract, there were no producing wells upon the property in question. (R. 21.)

As the oil was produced from the property here concerned, it was run into tanks, and division orders were executed to the pipe line companies, providing that the payment of the purchase price for the oil should be made directly to the operators,

the assignors, and the lessors, respectively, in accordance with their contractual rights. (R. 32.)

In their income tax returns for 1933, the taxpayers did not include the proceeds of sales of oil which were paid to Branson and Hammonds. The Commissioner of Internal Revenue assessed deficiencies based upon the inclusion of the amounts of these oil payments in the taxpayers' gross income. (R. 48.) The taxpayers were allowed depletion on this addition to their gross income. (R. 83.) After payment of the assessments, the taxpayers filed claims for refund of the tax computed upon the inclusion within their gross income of the oil payments to Branson and Hammonds. The claims for refund were rejected by the Commissioner. (R. 12.)

The taxpayers have admitted that if it is held that the oil payments should not be included in their gross income, the depletion deduction allowed to them must be reduced. (R. 83.)

The District Court held that the amount of these oil payments under the Hammonds and Branson assignment should be included within the gross income of the taxpayers. (R. 15–19.) The Circuit Court of Appeals in reversing the judgment held that the amount of the oil payments should be excluded from the taxpayers' income. (R.100.)

SPECIFICATION OF ERROR TO BE URGED

The Circuit Court of Appeals erred in holding that the amount of the oil payments made by the

taxpayers to Branson and Hammonds, the assignors, should be excluded from the gross income of the taxpayers.

SUMMARY OF ARGUMENT

The taxpayers and associates operated oil wells and sold the oil. The proceeds of all of the sales of oil made by them constituted income from their business and should be included in their gross income. Furthermore, they had by a contract of assignment acquired complete title to the oil leases under which they operated and also to all of the oil in place. By the provision in the contract of assignment of the leases for the payment of part of the consideration in the amount of $395,000 out of oil produced the assignors of the leases neither retained an interest in the leases nor in the oil in place. Since the capital and labor entering into the production of the income here in question was owned and furnished entirely by the taxpayers and their associates the entire proceeds of sales of oil made by them are to be included in their gross income. The payments made to the assignors of the leases out of oil produced constituted part of the purchase price of the leases and were a capital expenditure. The payments may not be deducted as an expense. The taxpayers recover back their capital outlay through an allowance for depletion.

ARGUMENT

THE TAXPAYERS' GROSS INCOME INCLUDES ALL OF THE PROCEEDS FROM THE SALE OF THE OIL PRODUCED

During the year 1933 the taxpayers, in association with another individual and a corporation, extracted oil and gas from certain wells in Texas under leases which had theretofore been assigned to them. As consideration for the assignment of the leases, the taxpayers and their associates had paid to the assignors $105,000 in cash and $50,000 in notes, and had agreed to pay the further sum of $395,000 out of one-fourth of the first oil produced. It was provided that the agreement to make the payment of $395,000 out of oil produced was not to impose a personal obligation upon the assignees of the leases. The question is whether the proceeds of sales of oil paid over to the assignors of the leases constituted income of the taxpayers and their associates.

It was argued below on behalf of the taxpayers that the assignment of the leases was not intended to convey and did not convey all of the assignors' interest in the oil in place or their "property right" or "economic interest" therein, but that there was a clear intention to retain title to a certain amount of oil, and that accordingly the assignors' situation was that of a part owner, and not that of a creditor. The court below, in reversing the decision of the District Court, deemed the question of title to the oil in the ground or that produced and saved until sold

unimportant, holding that the question of whose is the income from the production of oil should be approached from the broad and general view of local transactions which has been held proper in determining whose are the depletion deductions under the Federal tax statutes (citing *Palmer* v. *Bender*, 287 U. S. 551), and that from this approach it was plain that the assignors had an economic interest in the oil in place and that produced and sold; hence that the proceeds of the sales of oil which were paid over to the assignors were not income of the taxpayers.

At the outset, we do not admit that when an oil lease has been completely transferred by assignment for a stated sum of money, the assignors of the lease have such an economic interest in the oil in place as to entitle them to depletion, even though payment of a part of the agreed sum may be contingent upon the production of a certain quantity of oil. Several of the lower courts, purporting to follow this Court's decision in *Palmer* v. *Bender*, *supra*, have so held,[1] but we believe that those decisions constitute an unwarranted extension of the depletion statutes. However, the question of depletion is not now before the Court. It is clear that a decision of that question turns on the language of the depletion provisions of the statute and

[1] See *Commissioner* v. *Fleming*, 82 F. (2d) 324 (C. C. A. 5th); *Commissioner* v. *Elliott Petroleum Corporation*, 82 F. (2d) 193 (C. C. A. 9th); *Alexander, Collector* v. *Continental Petroleum Co.*, 63 F. (2d) 927 (C. C. A. 10th).

the peculiar benefits granted by those provisions. The sections of the statute to which we look to determine what is taxable income and to whom it shall be taxed are different from the depletion provisions, and an examination of them will disclose no basis for holding that an "economic interest" in the profits from another's capital or labor will exempt those profits from taxation to that person whose capital or labor produced the profits.

Section 11 of the Revenue Act of 1932 lays a normal tax upon the "net income of every individual", Section 12 provides for a surtax. In Section 22 "gross income" is defined as including "gains, profits, and income derived from * * * trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from * * * the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever."

In *Poe* v. *Seaborn,* 282 U. S. 101, 109–110, this Court considered similar provisions of the Revenue Act of 1926, and held that the test laid down by Congress for the income tax upon an individual is one of ownership, and that the answer to the question of ownership must be found in the provisions of the law of the State.

The most quoted definition of income is that it is the product of capital or labor, or both combined.

Accordingly, if we find that under state law a particular taxpayer owns the capital which enters into the production of particular income and also performs the labor entailed in its production, it follows that that taxpayer is taxable under the Federal revenue laws upon that income.

This Court in *Stratton's Independence* v. *Howbert,* 231 U. S. 399, 415, described the process of mining in the following language:

> But when a company is digging pits, sinking shafts, tunneling, drifting, stoping, drilling, blasting, and hoisting ores, it is employing capital and labor in transmuting a part of the realty into personalty, and putting it into marketable form. The very process of mining is, in a sense, equivalent in its results to a manufacuring process. And, however the operation shall be described, the transaction is indubitably "business" within the fair meaning of the act of 1909; and the gains derived from it are properly and strictly the income from that business; for "income" may be defined as the gain derived from capital, from labor, or from both combined, and here we have combined operations of capital and labor.

If, as held in the *Stratton's Independence* case *supra,* profits from the sales of mineral products are income from a business analogous to a manufacturing process, it would seem to follow that those who own and conduct that business are the ones to be taxed on its profits. It, of course, has not

been and cannot be argued that the persons who assigned the oil leases to the taxpayers and their associates were partners or co-adventurers in the conduct of the business of extracting the oil from the ground and putting it upon the market. The argument of the taxpayers is that the assignors formerly owned, and still retained an interest in, some of the property used in the business, that is, an interest in the oil in place and the oil produced and saved. We think, however, it is perfectly clear that the use by one in his business of property owned by another would not prevent the gain or profit arising out of the use of that property from being considered the income of the one conducting the business. If he has paid for the use of the property, then he must look to other provisions of the revenue laws to ascertain if he is entitled to a deduction for such payments.

Furthermore, the argument of the taxpayers that the assignors retained an interest in the oil in place and in the oil produced and saved is contrary to the plain terms of the contract of assignment and to the law of Texas. The assignment provided (R. 21–22):

> * * * in consideration of the sum of Ten Dollars ($10.00), cash in hand [actually, this part of the consideration was $105,000.00 in cash and $50,000.00 in notes (R. 27)], paid by Faith Oil Corporation, a Texas Corporation, and of the further sum of Three Hundred Ninety Five Thousand Dol-

> lars ($395,000.00) to be paid out of the oil produced and saved from the hereinafter described lands, and to be one-fourth of all the oil produced and saved from the premises hereinafter described, until the full sum of Three Hundred and Ninety Five Thousand Dollars ($395,000.00) is paid, we, * * *, the present owners of said leases hereinafter described and all rights thereunder and incident thereto, *do hereby bargain, sell, transfer, assign, and convey all our rights, title, and interest in and to said leases and rights thereunder,* hereinafter described, * * * to Faith Oil Corporation, its successors and assigns * * * [Faith Oil Corporation's interest in this assignment is ¼ and the taxpayers ⅜; R. 27–29, 21]. [Italics added.]

We should think that the italicized language above would be considered so clear as to admit of no doubt that the assignors assigned all of their interest in the leases and rights thereunder. An argument similar to that made by the taxpayers, however, was made before the Court of Civil Appeals of Texas in *Holliday* v. *Erwin,* 85 S. W. (2d) 355. The assignment involved in that case provided:

> Now, therefore, for and in consideration of the sum of Five hundred and no/100 dollars ($500.00) cash in hand paid, the receipt of which is hereby acknowledged, and the further sum of sixteen thousand two hundred fifty and no/100 dollars ($16,250.00)

> payable out of one-fourth (¼th) of seven-eighths (⅞th) of the first oil only as, if and when produced, saved and sold from the above described land, which sum is exclusive and in addition to the sum of seventy-five and No/100 dollars ($75.00) per acre payable to the original lessor under the terms of the original lease, the undersigned, the present owner of said lease and all rights thereunder or incident thereto, does hereby bargain, sell, transfer, assign and convey all rights, title and interest of the original lessee and present owner in and to said lease and rights thereunder, insofar as it covers the above described land, together with all personal property used or obtained in connection therewith to Walter D. Caldwell and his heirs, successors and assigns.

The plaintiff in that case, Erwin, was the assignor of the leases, and he sought, among other things, a decree declaring him to be the owner of one-fourth of seven-eighths of the first oil produced until the full sum of $16,250 had been paid to him. In rejecting his contention, the court said (p. 356):

> It is clear to our minds that in this assignment Erwin conveyed all rights, title, and interest which he held in said 50 acres of land for the consideration of $500 in cash and the further conditional promise to pay him the sum of $16,250, payable out of one-fourth of seven-eighths of the first oil, only, as, if, and when produced, saved, and sold from said 50 acres of land. The assignment

> does not contain a provision that Erwin is entitled to receive one-fourth of seven-eighths of the first oil produced, nor does it contain a provision that the title to such oil shall remain in Erwin until he is paid. He simply conveys all his rights in the lease for so much cash and a conditional promise to pay $16,250.

The taxpayers in the present case relied below principally upon *Sheffield* v. *Hogg*, 124 Tex. 290, 77 S. W. (2d) 1021. In *Holliday* v. *Erwin, supra*, a motion for rehearing was made upon the ground that the decision there was in conflict with *Sheffield* v. *Hogg, supra*. The court, in overruling the motion for rehearing, pointed out the differences between the two cases and stated that the assignor, Erwin, in the case before it, "was not to receive anything as rents or royalty; he was to receive purchase money." Cf. *Simms Oil Co.* v. *Colquitt*, 2 S. W. (2d) 421 (Tex.); and *Miller* v. *Hodges*, 260 S. W. 168 (Tex.). In this latter case, the court held that an assignment of all the "right, title, and interest in and to the leases aforesaid, and all rights thereunder" operated to convey the leases and as well to convey the same title to the minerals that the leases themselves conveyed. See also *Group No. 1 Oil Corp.* v. *Bass*, 283 U. S. 279, 281, where this Court quoted with approval from *Theisen* v. *Robison*, 117 Tex. 489, 510–511, as follows:

> They [the leases] do not authorize the purchaser to take and use seven-eighths or

> any other mere fractional part of the oil or gas in the land leased. The purchaser instead buys *all* the oil and gas, for a stipulated price, part of the price being measured by the value of a certain fraction of the *produced* oil and gas, which is a very different thing from the value of that fraction of the oil and gas in place. The leases convey all the oil and gas in granting the right to find, produce, and appropriate *all* of them, in consideration of the payment of stipulated sums and also the value of a stated fraction of the oil and gas produced.

It thus appears, we submit, that the taxpayers (and their associates) acquired the complete title to and interest in the leases under which the oil, the proceeds of which are in question here, was produced; they had under the law of Texas ownership of the oil in place; they alone had the right to extract the oil and sell it; and the business of extracting and selling the oil was operated solely by them for their own benefit. The profits of the business are therefore taxable to them. The fact that the assignors of the leases were to receive as part of the selling price of the leases a stated sum out of the proceeds of sale of certain of the oil does not make them partners in the business, nor prevent the income from the business from being taxed to its owners. The problem thus presented is not one peculiar to the oil industry, and it is not material to the solution of the problem that the payments to the assignors of the leases may be

called "oil payments", or that the payments are made directly to the assignors by the pipe line company. It is the same problem which is presented when any property or business is transferred and the purchase price is to be paid in part from the operations of the business.

Partnership contracts, for example, often provide that the estate of a deceased partner shall allow his interest to remain in the business in return for a share of the partnership earnings over a period of time. The courts have stated that such a transaction is a sale, and that the entire earnings are taxable to the surviving partners, with no expense deduction allowed to them for the payments to the estate of the deceased partner. *Hill* v. *Commissioner,* 38 F. (2d) 165 (C. C. A. 1st), certiorari denied, 281 U. S. 761; *Pope* v. *Commissioner,* 39 F. (2d) 420 (C. C. A. 1st). Cf. *Bull* v. *United States,* 295 U. S. 247, 254.

Corporations not infrequently enter into contracts with their officers and employees to pay them as compensation a certain percentage of the net profits of the business of the corporation. See *S. Naitove & Co. Inc.* v. *Commissioner,* 32 F. (2d) 949 (App. D. C.), certiorari denied, 280 U. S. 582; *Rogers* v. *Hill,* 289 U. S. 582. The fact that the employees share in the net profits does not provide a ground for the exclusion of those profits from the gross income of the corporation. Whether the corporation may be permitted an offsetting deduction depends upon other considerations.

That profits earned by a taxpayer are taxable to him without regard to whether they are directly received by him is, we submit, well settled. Cf. *Old Colony Trust Co.* v. *Commissioner,* 279 U. S. 716, where an employee was required to include in his income money which his employer paid directly over to the United States to satisfy a tax upon the employee; *Douglas* v. *Willcuts,* 296 U. S. 1, where a husband was taxed with the income from a trust created by him providing for annual payments to his divorced wife in lieu of alimony; *Burnet* v. *Leininger,* 285 U. S. 136, 141, where a husband was taxed with the entire income from his interest in a partnership, notwithstanding the prior assignment of one-half of the "corpus" of his interest to his wife; and *West End St. Ry. Co.* v. *Malley,* 246 Fed. 625 (C. C. A. 1st), and *Rensselaer & S. R. Co.* v. *Irwin,* 249 Fed. 726 (C. C. A. 2d), where a corporation leasing property was taxed with amounts paid directly to its stockholders by the lessee.

In *Comar Oil Co.* v. *Burnet,* 64 F. (2d) 965 (C. C. A. 8th), certiorari denied, 290 U. S. 652, contracts essentially similar to that in the instant case were involved, and the same question here presented was raised. The court in that case held that the assignor of the leases had completely conveyed whatever title he had and that the oil payments to the assignor, called "overriding royalties", were not to be excluded from the income of

the assignee, nor were deductions allowed for the payments.

This conclusion accords in principle with the earlier decisions of the court below in *Pugh* v. *Commissioner*, 49 F. (2d) 76, certiorari denied, 284 U. S. 642; *Herold* v. *Commissioner*, 42 F. (2d) 942; *Waller* v. *Commissioner*, 40 F. (2d) 892; and the decisions of the Third and Sixth Circuits in *Jefferson Gas Coal Co.* v. *Commissioner*, 52 F. (2d) 120 (C. C. A. 3d) and *Eldredge* v. *United States*, 31 F. (2d) 924 (C. C. A. 6th).

From the foregoing, we submit that the court below was in error in holding that the proceeds of sales of oil paid over to the assignors of the leases were not income of the taxpayers.

II

THE TAXPAYERS ARE NOT ENTITLED TO A DEDUCTION ON ACCOUNT OF THE PAYMENTS TO THE ASSIGNORS OF THE LEASES

In the court below the taxpayers devoted their argument principally to the contention that the proceeds of oil paid over to the assignors of the leases were not income to the assignees, the taxpayers, and the court below agreed with their contention. If this Court, however, should not uphold the lower court's decision, the taxpayers will doubtless contend that they are entitled to a deduction from gross income on account of the payments made to their assignors.

To be entitled to a deduction a taxpayer must show that such deduction is clearly authorized by statute. Our contention is that the payments made to the assignors were part of the purchase price of the leases, and as such represented a capital expenditure to be recovered in the allowance made by the statute for depletion. There can be no duplicate allowance for those disbursements as a separate deduction. Admittedly, in this case the taxpayers have received the benefit of a depletion allowance not only on the proceeds of sales of oil which they retained but also on the proceeds of sales of oil which were paid over to the assignors. There is no provision of statute to which they can point authorizing any other deduction. The only possible contention that could be made is that these payments to the assignors were in the nature of "rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity." Section 23, Revenue Act of 1932, *infra,* pp. 21–22. The taxpayers stated in their brief below, however, that these payments did not purport to be rents or royalties, and clearly they were not. They were part of the purchase price of the leases, a capital asset. *Consolidated Royalty Oil Co.* v. *Commissioner,* 31 B. T. A. 107; *Comar Oil Co.* v. *Burnet, supra.* The Court of Civil Appeals of Texas in *Holliday* v.

Erwin, supra, settled that question where an assignment in all material respects like the assignment in the present case was involved. As stated above, the court there held that "Defendant in error [the assignor] was not to receive anything as rents or royalty; he was to receive purchase money."

This Court in *Duffy* v. *Central R. R.*, 268 U. S. 55, had before it the statutory provision for deduction of rentals and "other payments", and there concluded, pages 63–64, that "The term 'rentals,' since there is nothing to indicate the contrary, must be taken in its usual and ordinary sense, that is, as implying a fixed sum, or property amounting to a fixed sum, to be paid at stated times for the use of property," and that the phrase "or other payments" was "meant to bring in payments *ejusdem generis* with 'rentals,' such as taxes, insurance, interest on mortgages, and the like, constituting liabilities of the lessor on account of the leased premises which the lessee has covenanted to pay." In that case this Court held that expenditures which a lessee was required to make for betterments and additions to leased premises could not be deducted under the term "rentals", but that the lessee might obtain a return of its expenditures by an annual depreciation.

In the present case the capital expenditure to purchase the leases is recovered back through the allowance for depletion. *Lynch* v. *Alworth-Ste-*

phens Co., 267 U. S. 364, 370. Cf. *Baton Coal Co.* v. *Commissioner*, 51 F. (2d) 469 (C. C. A. 3d).

We submit, therefore, that under the terms of the contract of assignment the title to the leases, title to all of the oil and gas in place, and the exclusive right to extract and sell that oil and gas passed to the taxpayers and their associates. The income from the operation of the wells and sales of the oil was chargeable in its entirety to them. The oil payments merely represented a portion of the purchase price of the leases and were not deductible, since they were capital expenditures.

CONCLUSION

For the foregoing reasons it is respectfully submitted that the decision of the court below should be reversed.

Respectfully submitted.

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APRIL 1937.

APPENDIX

Revenue Act of 1932, c. 209, 47 Stat. 169:

SEC. 11. NORMAL TAX ON INDIVIDUALS.

There shall be levied, collected, and paid for each taxable year upon the net income of every individual a normal tax equal to the sum of the following:

* * * * *

SEC. 12. SURTAX ON INDIVIDUALS.

(a) *Rates of Surtax.*—There shall be levied, collected, and paid for each taxable year upon the net income of every individual a surtax as follows:

* * * * *

SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

(a) *Expenses.*—All the ordinary and necessary expenses paid or incurred during the

taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; traveling expenses (including the entire amount expended for meals and lodging) while away from home in the pursuit of a trade or business; and rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.

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